

Meridian Energy

NEUTRAL

Aluminium Smelts Share Price

The negative reaction to the NZAS strategic review has been greatest for Meridian Energy (MEL), we believe unjustifiably so and are upgrading our rating to NEUTRAL. MEL's share price has fallen -15% in the two weeks following the NZAS announcement, the most of any electricity stock. Whilst we believe the share price reaction is an overreaction, in our view MEL was previously the most expensive electricity stock, hence, it has only moved back into fair value territory.

What's changed?

- **Earnings:** FY20/FY21 EBITDAF -\$4m/-\$17m to \$816m/\$752m
- **Target Price:** Reduced -14cps (-3.3%) to \$4.11
- **Rating:** Upgraded to NEUTRAL

MEL's best case scenario is dropping NZAS's electricity price

Whilst MEL has no intention of "taking one for the team", we suspect the team is unwilling to play ball (with the probable exception of Contact Energy). With MEL likely to be the most impacted generator/retailer (in the short-term at least) we expect it will offer NZAS a reduced electricity price — albeit well short of what NZAS probably wants. We have built in a -\$3/MWh lower electricity price from FY21 onwards, which equates to ~\$13m per annum.

If NZAS were to close, the short-term impacts on MEL would predominantly be reduced generation volumes at lower prices until transmission constraints are removed in the lower South Island. However, the transmission work is unlikely to be completed until 2024 (assuming NZAS closure in 2021). Long-term MEL is better placed as its low cost generation means it will not have to close any generation plant and it should receive a higher electricity price for its generation than what it has been receiving from NZAS. We have lowered our target price -14cps (-3.3%, NZAS closure risk weighting of 20%) to account for the risks associated with NZAS closing.

Development and dividend implications

Whilst NZAS closure risk overhangs MEL it is hard to see the Board signing off on a new wind farm development. That said, with MEL unable to build during winter and financial close not expected to 2020 at the earliest, we do not expect a material delay if NZAS decides to stay.

The other implication for MEL is: what will it do after the special dividend ends following the 1H22 result? We had been expecting MEL to update the market on its thinking at the 1H20 result. The wind farm development was MEL's ticket to possibly maintaining the current total dividend of ~21.5cps. However, with the NZAS strategic review not expected to be completed until March 2020, MEL will probably defer its capital management update.

Investment View

Our rating is NEUTRAL. MEL has been the strongest electricity performer in recent years and its low cost generation assets provides it with a strong defensive position. Its dividend yield is attractive, although we expect that will fall in FY22 when the current capital management programme ends.

NZX Code	MEL
Share price	NZ\$4.60
Target price	NZ\$4.11
Risk rating	Low
Issued shares	2563.0m
Market cap	NZ\$11,790m
Average daily turnover	1,449k (NZ\$6,174k)

Share Price Performance



Financials: June	19A	20E	21E	22E
NPAT* (NZ\$m)	481.3	477.2	426.9	434.0
EPS* (NZc)	18.8	18.6	16.7	16.9
EPS growth* (%)	33.4	-0.8	-10.5	1.6
DPS (NZc)	21.3	21.5	21.6	20.4
Imputation (%)	66	65	65	70

Valuation (x)	19A	20E	21E	22E
EV/EBITDA	15.8	16.2	17.7	17.3
EV/EBIT	23.5	26.1	29.5	28.2
PE	24.5	24.7	27.6	27.2
Price / NTA	2.2	2.3	2.4	n/a
Cash dividend yield (%)	4.6	4.7	4.7	4.4
Gross dividend yield (%)	5.8	5.8	5.9	5.6

*Historic and forecast numbers based on underlying profits

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Meridian Energy Limited (MEL)		Priced as at 06 Nov 2019: NZ\$4.60					June year end					
Forsyth Barr valuation							Valuation Ratios					
Valuation methodology		Mix of market multiple and DCF					2018A	2019A	2020E	2021E	2022E	
12-month target price (NZ\$)*		4.11		Spot valuations (NZ\$)			EV/EBITDA (x)	19.7	15.8	16.2	17.7	17.3
Expected share price return	-10.7%	1. DCF	3.73			EV/EBIT (x)	32.9	23.5	26.1	29.5	28.2	
Net dividend yield	4.7%	2. Market multiple	4.18			PE (x)	32.7	24.5	24.7	27.6	27.2	
Estimated 12-month return	-6.0%	3. Dividend yield	4.48			Price/NTA (x)	2.5	2.2	2.3	2.4	2.6	
Key WACC assumptions		DCF valuation summary (NZ\$m)					Free cash flow yield (%)	1.5	4.8	4.2	3.8	4.0
Risk free rate	2.00%	Total firm value	11,316			Net dividend yield (%)	4.2	4.6	4.7	4.7	4.4	
Equity beta	0.84	(Net debt)/cash	(1,761)			Gross dividend yield (%)	5.3	5.8	5.8	5.9	5.6	
WACC	6.7%	Value of equity	9,555			Imputation (%)	68	66	65	65	70	
Terminal growth	1.5%	Shares (m)	2,563			Pay-out ratio (%)	136	113	115	130	121	
Profit and Loss Account (NZ\$m)							Capital Structure					
Sales revenue	3,297	2018A	2019A	2020E	2021E	2022E	2018A	2019A	2020E	2021E	2022E	
Normalised EBITDA	666	838	816	752	767	Interest cover EBIT (x)	4.7	6.6	6.0	5.2	5.2	
Depreciation and amortisation	(268)	(276)	(309)	(302)	(296)	Interest cover EBITDA (x)	8.2	10.1	10.0	9.0	8.8	
Normalised EBIT	398	562	507	450	470	Net debt/ND+E (%)	23.2	20.7	22.1	24.5	26.6	
Net interest	(81)	(83)	(81)	(83)	(87)	Net debt/EBITDA (x)	2.2	1.7	1.8	2.1	2.2	
Associate income & other	(19)	(14)	(17)	(19)	(19)	Key Ratios						
Tax	(95)	(133)	(114)	(97)	(102)	Return on assets (%)	4.4	5.7	5.2	4.7	5.1	
Minority interests	-	-	-	-	-	Return on equity (%)	4.3	6.1	5.7	5.1	5.7	
Reported NPAT	203	332	294	250	263	Return on funds employed (%)	4.6	5.9	5.5	5.0	5.4	
Abnormals/other	158	149	183	177	171	EBITDA margin (%)	20.2	20.4	21.9	21.5	22.5	
Adjusted normalised NPAT	361	481	477	427	434	EBIT margin (%)	12.1	13.7	13.6	12.9	13.8	
Adjusted normalised EPS (cps)	14.1	18.8	18.6	16.7	16.9	Capex to sales (%)	7.5	1.7	2.0	2.2	1.7	
DPS (cps)	19.2	21.3	21.5	21.6	20.4	Capex to depreciation (%)	100	28	27	27	21	
Growth Rates							Operating Statistics					
Revenue (%)	16.7	2018A	2019A	2020E	2021E	2022E	2018A	2019A	2020E	2021E	2022E	
EBITDA (%)	1.4	24.5	-9.2	-6.3	-2.3	Hydro generation	11,266	12,326	11,967	11,701	11,701	
EBIT (%)	1.3	25.8	-2.6	-7.9	2.0	Wind generation	1,263	1,244	1,470	1,474	1,474	
Normalised NPAT (%)	-3.1	41.2	-9.8	-11.3	4.6	Total NZ generation (GWh)	12,528	13,570	13,436	13,175	13,175	
Normalised EPS (%)	-3.1	33.4	-0.8	-10.5	1.6	GWAP (\$/MWh)	83.0	123.3	114.0	96.4	85.8	
DPS (%)	1.5	10.9	0.9	0.8	-5.7	Overseas generation (GWh)	581	730	725	800	800	
Cash Flow (NZ\$m)							Overseas GWAP (\$/MWh) (NZD)	151	100	137	105	96
EBITDA	666	838	816	752	767	Overseas customer numbers (000)	97	110	127	143	153	
Working capital change	(34)	(36)	7	13	16	Powershop customers (000)	66	74	80	82	83	
Interest & tax paid	(186)	(200)	(237)	(222)	(231)	Meridian branded customers (000)	225	228	235	240	245	
Other	(19)	33	(17)	(19)	(19)	NZ electricity customers (000)	291	302	315	321	328	
Operating cash flow	427	635	569	523	533	Average usage per cust (MWh/yr)	13.5	13.2	12.9	12.9	12.9	
Capital expenditure	(247)	(69)	(75)	(76)	(58)	Mass market volumes	3,824	3,901	3,989	4,094	4,180	
(Acquisitions)/divestments	23	-	-	-	-	Time of use volumes	2,157	2,338	2,721	2,742	2,764	
Other	-	-	-	-	-	Total fixed price volumes (GWh)	5,981	6,239	6,710	6,836	6,944	
Funding available/(required)	203	566	494	447	475	NZAS sales	5,011	5,310	5,464	5,449	5,449	
Dividends paid	(486)	(500)	(550)	(555)	(557)	Sell CFDs	2,278	2,239	1,967	1,967	1,967	
Equity raised/(returned)	(2)	(2)	-	-	-	Buy CFDs	-2,222	-1,965	-1,938	-1,740	-1,740	
Increase/(decrease) in net debt	285	(64)	56	108	82	Total Sales (GWh)	11,047	11,823	12,202	12,511	12,619	
Balance Sheet (NZ\$m)							Average FPV price (\$/MWh)	105.2	104.8	106.8	108.3	109.5
Working capital	(17)	2018A	2019A	2020E	2021E	2022E	LWAP (\$/MWh)	88	132	123	104	93
Fixed assets	7,941	8,825	8,599	8,377	8,139	LWAP/GWAP	1.06	1.07	1.08	1.07	1.08	
Intangibles	60	59	51	47	47	Lines losses (%)	5.3	5.9	5.5	5.5	5.5	
Other assets	291	383	366	347	328	New Zealand Energy Margin (\$m)	944	1,108	1,077	1,001	1,004	
Total funds employed	8,275	9,243	9,002	8,764	8,510	Overseas Energy Margin (\$m)	86	118	118	114	114	
Net debt/(cash)	1,461	1,424	1,480	1,588	1,670	Meridian Energy Margin (\$m)	1,030	1,226	1,195	1,116	1,118	
Other non current liabilities	1,991	2,362	2,321	2,280	2,238							
Shareholder's funds	4,823	5,457	5,201	4,897	4,602							
Minority interests	-	-	-	-	-							
Total funding sources	8,275	9,243	9,002	8,764	8,510							

* Forsyth Barr target prices reflect valuation rolled forward at cost of equity less the next 12-months dividend

Summary forecast changes

Figure 1. Summary forecast changes

	FY20	FY20		FY21	FY21		FY22	FY22	
	Old	New	% Chg	Old	New	% Chg	Old	New	% Chg
NZ Energy Margin	1,080	1,077	-0.3%	1,019	1,001	-1.7%	1,023	1,004	-1.9%
Australia Energy Margin	118	118	0.0%	114	114	0.0%	114	114	0.0%
EBITDAF	820	816	-0.4%	769	752	-2.3%	786	767	-2.5%
EBIT	510	507	-0.6%	467	450	-3.7%	490	470	-4.0%
Pre-tax profit	412	409	-0.8%	365	347	-4.9%	385	365	-5.3%
NPAT	297	294	-0.8%	263	250	-4.9%	277	263	-5.3%
Dividend (cps)	21.6	21.5	-0.3%	21.8	21.6	-0.6%	20.9	20.4	-2.5%
NZ Generation (GWh)	13,436	13,436	0.0%	13,175	13,175	0.0%	13,175	13,175	0.0%
FPVV sales (GWh)	6,710	6,710	0.0%	6,836	6,836	0.0%	6,944	6,944	0.0%
Customer numbers (000)	315	315	0.0%	321	321	0.0%	328	328	0.0%
GWAP (\$/MWh)	\$115.4	\$114.0	-1.2%	\$99.2	\$96.4	-2.8%	\$90.7	\$85.8	-5.4%

Source: Forsyth Barr analysis

Investment summary

Our rating is NEUTRAL. MEL has been the strongest electricity performer in recent years and its low cost generation assets provides it with a strong defensive position. Its dividend yield is attractive, although we expect that will fall in FY22 when the current capital management programme ends.

Business quality

- **Low risk, modest growth industry:** Electricity demand is inelastic and the industry is well positioned to benefit from NZ electrifying transport and industrial processes.
- **Strong generation position:** Most of the value within the electricity sector lies within the generation assets. MEL is the largest generator in New Zealand, producing ~32% of New Zealand's electricity requirements and controls ~50% of New Zealand's hydro storage. It is also the lowest cost generator.
- **Track record:** Since listing in 2014, MEL has demonstrated an ability to unlock value and has lifted operating earnings +25%.

Earnings and cash flow outlook

- **More modest growth after FY19:** We expect earnings growth to slow after the stellar FY19 year (although early indications are positive for FY20). We expect transmission benefits to be offset by a gradually declining wholesale electricity price.
- **Cash flow strong in near-term:** Limited electricity demand growth means capital expenditure is limited, resulting in strong free cash flows.

Financial structure

- **Balance sheet:** Management recognises that surplus cash is better with shareholders. MEL currently has spare capacity on its balance sheet and hence it has in place a capital management plan that is gradually lifting gearing.
- **Dividends:** MEL's strong free cash flow enables it to pay high dividends, which are currently elevated due to the capital management plan.

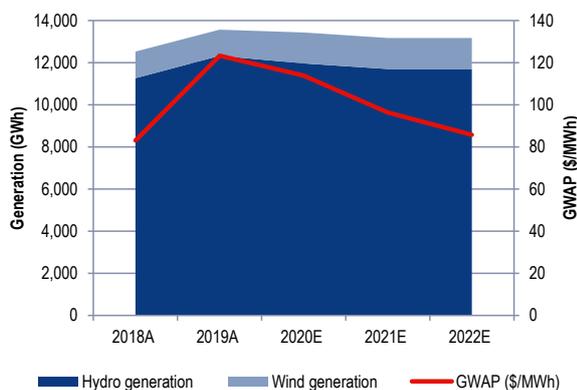
Key risks

- **Political/regulatory:** The 2014 election and recent Electricity Price Review (EPR) highlighted the political/regulatory risks inherent in the sector. Whilst the EPR gave the sector a thumbs up in most areas, the political risk is unlikely to ever disappear.
- **NZAS risk:** NZAS has indicated it is undertaking a strategic review, raising the possibility it may close. In our view, the smelter is unlikely to close (less than 10% chance) and the downside risks are fully factored into the share price.
- **Rising bond yields:** In recent years MEL has traded in line with bond yields. A lift in interest rates is likely to see MEL trade lower.

Company description

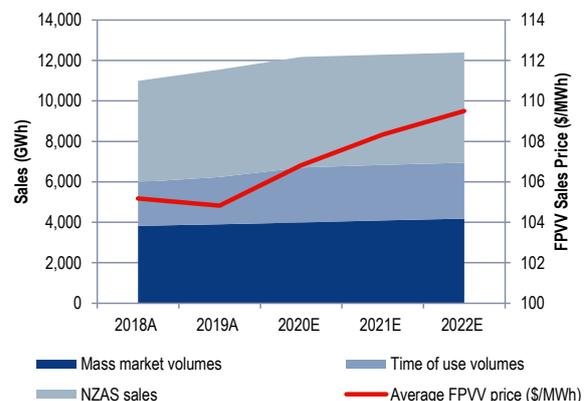
Meridian is New Zealand's largest electricity generator/retailer. It produces ~11,500GWh of electricity from its South Island hydro power stations and ~1,500GWh from its predominantly North Island wind farms. MEL's retail brands, Meridian and Powershop retail electricity to around 290,000 customers. MEL also has an international presence in Australia owning two wind farms and has launched its Powershop retail brand in Victoria and NSW. MEL's largest customer is New Zealand's largest power user, the Tiwai Point aluminium smelter which consumes ~13% of New Zealand's power and ~40% of MEL's output.

Figure 2. Generation volumes and average price received



Source: MEL, Forsyth Barr analysis

Figure 3. Sales volumes and average selling price



Source: MEL, Forsyth Barr analysis

Figure 4. Substantial Shareholders

Shareholder	Latest Holding
NZ Govt	51.0%

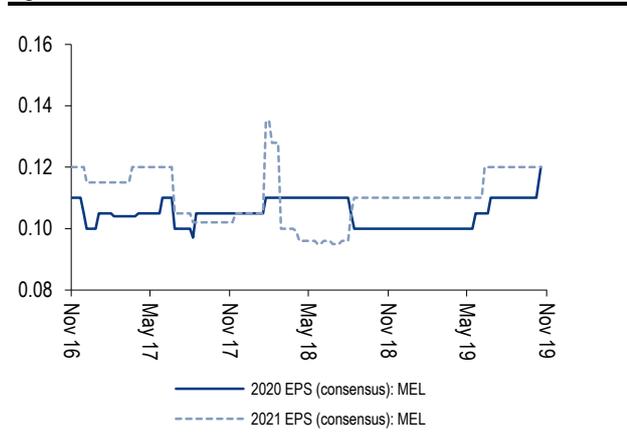
Source: NZX, Forsyth Barr analysis, NOTE: based on SSH notices only

Figure 5. International Compcos

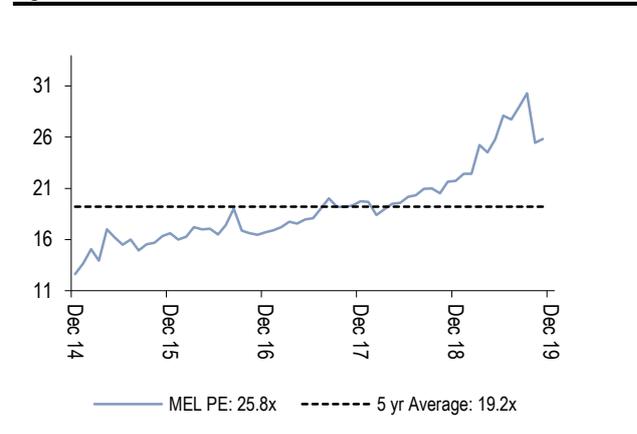
Company	Code	Price	Mkt Cap	PE		EV/EBITDA		EV/EBIT		Cash D/Yld	
<i>(metrics re-weighted to reflect MEL's balance date - June)</i>											
			(m)	2020E	2021E	2020E	2021E	2020E	2021E	2021E	
Meridian Energy	MEL NZ	NZ\$4.60	NZ\$11,790	24.7x	27.6x	16.2x	17.6x	26.1x	29.4x	4.7%	
Contact Energy *	CEN NZ	NZ\$7.25	NZ\$5,204	20.9x	20.0x	13.2x	12.7x	23.3x	21.8x	5.4%	
Genesis Energy *	GNE NZ	NZ\$3.18	NZ\$3,274	20.9x	16.5x	12.2x	10.9x	28.9x	22.7x	5.6%	
Mercury *	MCY NZ	NZ\$4.87	NZ\$6,634	26.7x	24.2x	15.0x	14.7x	24.5x	24.2x	3.3%	
Trustpower *	TPW NZ	NZ\$8.26	NZ\$2,585	24.4x	23.5x	14.9x	14.4x	18.7x	18.0x	4.3%	
AGL Energy	AGL AT	A\$19.66	A\$12,760	15.1x	15.1x	7.4x	7.3x	11.2x	11.4x	5.0%	
ERM Power	EPW AT	A\$2.41	A\$603	12.1x	16.2x	7.1x	6.7x	10.1x	9.5x	4.2%	
Infigen Energy	IFN AT	A\$0.65	A\$621	13.7x	18.4x	6.9x	7.8x	11.0x	13.7x	3.1%	
Origin Energy	ORG AT	A\$8.07	A\$14,213	13.7x	13.2x	6.3x	6.2x	13.8x	13.4x	4.5%	
				Compcos Average:	18.4x	18.4x	10.4x	10.1x	17.7x	16.8x	4.4%
				MEL Relative:	+34%	+50%	+56%	+74%	+47%	+75%	+6%

EV = Current Market Cap + Actual Net Debt

Source: *Forsyth Barr analysis, Bloomberg Consensus, Compcos metrics re-weighted to reflect headline (MEL) companies fiscal year end

Figure 6. Consensus EPS Momentum


Source: Forsyth Barr analysis, Bloomberg

Figure 7. 12 Month Forward PE


Source: Forsyth Barr analysis

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